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Using Credit to Treat Rural Problems: Lessons from Four Decades of Experience

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Rural credit programs have been used extensively since the early 1950s to stimulate production, to increase use of new technologies, and to ease poverty.[1] Most governments in low-income countries climbed on the credit-led-development bandwagon with generous support from donors such as the World Bank, the Inter-American Development Bank, the Agency for International Development, and the Food and Agriculture Organization. The World Bank alone allocated almost US$17 billion to agricultural credit through about 700 projects since the early 1950s.[2] Most of these programs included subsidized interest rates, targeted loans, and specialized agricultural credit institutions. For three decades policy makers and donors used credit as if it were the all-purpose "antibiotic" for treating rural problems.

Despite a few successes, many of these credit efforts yielded disappointing results. Loan recovery problems, subsidy dependency, and insolvent financial institutions characterized many of these efforts (Adams and others 1987; Yaron 1992). Chronic problems led several major donors and numerous governments to shun traditional agricultural credit programs. When the final chapter on the history of these programs is written it should summarize the major lessons learned from this checkered experience. I suggest the following ten lessons for that summary.

LESSONS

LESSON ONE: Subsidized credit failed to treat rural poverty (Gonzalez-Vega 1977). Subsidies attached to loans come in two forms: concessionary interest rates and loan defaults. Both subsidies are proportional to loan size: large loan, large subsidy; small loan small subsidy; and no loan no subsidy. Since poor people usually receive only small loans or no loans, and individuals who are better off economically have easier access to loans than do poor people, the overall impact of subsidized loans

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[1] For a sampling of early thinking about these activities see Bauer 1952, Fernandez y Fernandez 1972, Food and Agriculture Organization 1965, and United Nations 1954.

[2] See Donald 1976 and World Bank 1993a for evaluations of the rural credit activities of the Agency for International Development and the World Bank.

on income distributions is regressive. Furthermore, low interest rates on loans discourage lenders from offering credit to poor people and also force intermediaries to pay even lower rates on deposits to the determent of poor people who may have few options to save aside from deposits.

LESSON TWO: Credit also proved to be a weak instrument for stimulating agricultural production, farm investments, and use of new technology (Rosengrant and Herdt 1981). Loans, regardless of the interest rates attached to them, do not alter the various returns from economic activities available to borrowers, including consumption. A cheap loan does not make an unprofitable activity profitable. Prices of farm products, prices and availability of modern farm inputs, law-and-order, and access to new technology have a far stronger impact on farmers' decisions than do loans. Lending should follow, not lead economic opportunity.

LESSON THREE: Using rural financial markets to allocate subsidies tied to loans, combined with extensive loan targeting, increased transaction costs for both lenders and borrowers (Cuevas and Graham 1984). These costs discouraged financial institutions from lending to targeted individuals and induced lenders to transfer additional transaction costs to non-preferred borrowers who were often the target group. This, in turn, dampened the demand for loans among the targeted group. Elevated transaction costs restrained the financial system from expanding into rural areas, from making small loans, and from seeking new clients (Von Pischke 1991).

LESSON FOUR: The repression of rural financial markets caused by low interest rates and excessive transaction costs shrunk the ability of these markets to intermediate between surplus and deficit units (Shaw 1973). Some rural firms may lack funds to respond to economic opportunities that promise high rates of return at the same time that other firms or households have surplus resources they are unable to employ productively. A financial system intermediates between these surplus and deficit units by accepting deposits and by making loans on the basis of creditworthiness, thereby allocating resources more efficiently. Only a healthy formal financial system can perform this delicate and diffused function.

LESSON FIVE: A much larger number of people can benefit from deposit services than gain from borrowing (Vogel 1984). Many rural people are willing and able to save via deposits if given the opportunity and proper incentives. Deposit mobilization also imposes discipline on intermediaries (Poyo 1992). They are generally more careful in lending when using depositors' funds than they are when using government or donor funds. The most successful rural financial systems have been built on deposits.

LESSON SIX: Loan recovery problems are usually less severe in institutions that mobilize deposits, that avoid transitory credit programs, and that are viewed as being dependable and durable (Patten and Rosengard 1991; Poyo 1992). Financial programs that are perceived to be of high quality and that involve procedures which impose few transaction costs on clients are usually associated with better loan recovery performance than are programs without these characteristics. The quality of the relationship between borrowers and lenders strongly influences loan repayment.

LESSON SEVEN: Non-farm rural enterprises are an increasingly important source of income for rural people (Liedholm and Mead 1987). Rural financial institutions should, therefore, offer financial services--both loans and deposits--to any firm or household in rural areas, including microenterprises (Gonzales-Vega and Sanabria 1993). In addition, many opportunities exist for providing financial services to women, particularly deposit accounts.

LESSON EIGHT: Informal finance provides sustained financial services to a larger number of rural people than does the formal financial system in many countries.[3] These arrangements vary from simple loans among friends and relatives, to groups that both save and lend (tandas, being examples), to loans tied to marketing activities, and to informal organizations that operate as quasi-banks. Research has shown that competition, rather than monopoly, characterizes most transactions in informal finance. It may be more appropriate, therefore, to view informal finance as a useful supplement to formal finance, rather than as a nuisance that must be eliminated.

LESSON NINE: Equity funding may be a more appropriate way to encourage the formation of successful new firms, such as agribusinesses, than is medium- and long-term debt. Equity is easier for new firms to manage than is debt and equity participation allows the funding organization to capture additional gains from successful firms that offset the losses from ventures that fail.

LESSON TEN: Specialized agricultural lending institutions are accident prone, are vulnerable to political intrusions, and often do not mobilize deposits (Ladman and Tinnermeier 1981). Instead of creating such organizations it is more appropriate to encourage the development of several institutions that compete, and at the same time offer financial services to various segments of the rural population. This might include grass roots organizations such as credit unions, other types of non-governmental organizations, cooperatives, and private banks. Any type of organization that can provide sustained financial services, and also be self sustaining, should be encouraged.

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[3]There is a rapidly growing literature on informal finance. For examples see: Adams and Fitchett 1992; Kurtz and Showman 1978; and Velez-Ibanez 1983.

CONCLUSIONS

The lessons learned from four decades of traditional agricultural credit programs have resulted in both a broadening and a narrowing of views. Concerns have broadened from simply providing agricultural credit to providing loans for any creditworthy individual or firm in rural areas and also to offering deposit services. Because of this broadening, the term 'rural finance' is increasingly replacing the term 'agricultural credit'. At the same time, there has been a narrowing in the perception of what can be accomplish with credit programs. There is increasing disillusionment with using credit to treat poverty and with using credit to prompt production and investment. Instead, many policy makers and donors have stepped off the credit-led bandwagon and are now focusing on how to develop efficient financial systems that provide sustained financial services--loans as well as deposits--to people living in rural areas (World Bank 1993b).

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